United States Court of Appeals

for the Second Circuit

AMICUS BRIEF

74-2582

United States Court of Appeals

FOR THE SECOND CIRCUIT

ROSALIND FOGEL, *et ano.*,

Plaintiffs-Appellants,

versus

GEORGE A. CHESTNUTT, JR., *et al.*,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF ON BEHALF OF LORD, ABBETT & CO. AS AMICUS CURIAE

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Preliminary Statement

Plaintiffs claim that defendants had a duty to recapture brokerage commissions by two basic schemes. They first contend that defendant Chestnutt Corporation ("Adviser") should have joined the National Association of Securities Dealers and used such membership to engage in various methods of what has been referred to as "NASD recapture". Judge Wyatt held that this claim must fail because the Adviser could not properly become a member of the NASD. Plaintiffs also contend that recapture should have been accomplished through the Adviser's joining the PBW Stock Exchange and sharing in commissions on the Fund's trades on that exchange. Judge Wyatt held that this step was not required since such institutional membership was contrary to public policy.

Although we agree with and urge that the decision below be affirmed on those grounds, we do not discuss them at any length in this brief since they are adequately covered in

Judge Wyatt's opinion and in defendants' brief on this appeal.

The purpose of this brief is to show (in the event that this Court disagrees with Judge Wyatt's reasoning) that the record establishes at least three further reasons why all of plaintiffs' claims must fail and why Judge Wyatt's decision should be affirmed. These reasons are:

1. Even if the Adviser could properly have become a member of NASD, defendants still could not have engaged in NASD recapture or the other methods of recapture suggested by plaintiffs without either violating the law or assuming serious legal risks (pp. 3-33, *infra*).

2. Defendants' reliance in good faith on the advice of their counsel that such recapture was legally impossible precludes any liability (pp. 33-34, *infra*).

3. Apart from questions of illegality or reliance on legal advice, there was still no duty to recapture (pp. 35-42, *infra*).

Lord, Abbett's Interest in This Appeal

Lord, Abbett & Co. is the investment adviser and principal underwriter for several investment companies and is one of the defendants in a pending derivative action brought on behalf of one of them, *Papilsky* v. *Berndt,* 71 Civ. 2534, which is pending before Judge Frankel and which has been before this Court on two occasions on procedural matters. 466 F.2d 251 (2d Cir. 1972) and 503 F.2d 554 (2d Cir. 1974). Counsel for plaintiffs in the instant case are thoroughly familiar with the *Papilsky* case since they are also counsel for the plaintiff in that case.

The claims made against Lord, Abbett in the *Papilsky* case are similar to the claims made against defendants in

the instant case. At its trial, Lord, Abbett plans to advance a number of reasons not fully dealt with by Judge Wyatt or defendants why the case against it should be dismissed, including the three reasons stated above. Since these reasons are fully applicable to the instant case, they ought to be considered by this Court if it has any inclination to reject the reasoning of the court below.

I.

Plaintiffs' Proposed Methods of Recapture Were All Unlawful

In Part A of this section we show that NASD recapture of give-ups was unlawful. Parts B and C respectively make similar showings as to acting as an "introducing broker" for the sole purpose of recapturing of stock exchange commissions and as to NASD recapture of tender offer fees. Part D discusses the serious consequences that might have resulted if such methods of recapture had been engaged in and been held unlawful. We do not discuss the question whether there is a duty to form a bona fide active public brokerage affiliate since plaintiffs appear not to be pressing this contention on appeal.

A. NASD Recapture of Give-Ups Was Unlawful

Pursuant to the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), all national securities exchanges were made subject to the supervision of the SEC. Section 6(a)* of the Act requires exchanges to register with the Commission and Section 6(b) provides that no registrations are to be granted or remain in force unless the rules of the ex-

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* All references to the Securities Exchange Act in this brief are to the Act as in effect prior to the Securities Act Amendments of 1975.

change include provisions for the expulsion or suspension of members for conduct or proceedings "inconsistent with just and equitable principles of trade." Pursuant to Sections 6(a)(3) and (4), all exchange rules and all amendments to rules must be filed with the SEC which has authority under Section 19(b) to alter or supplement, after notice and opportunity for hearing, exchange rules relating to "the fixing of reasonable rates of commission" and anti-rebate rules, *Gordon* v. *New York Stock Exchange*, 498 F.2d 1303, 1310 (2d Cir. 1974), *aff'd*, 43 U.S. L.W. 4958 (1975). The exchanges were permitted to fix minimum commissions until the SEC recently required that minimum commissions rules be eliminated.*

It is undisputed that at all relevant times during the minimum commission era all national stock exchanges had constitutional provisions providing that all customers were to be charged the full minimum commissions and which strictly forbade any rebates, direct or indirect, to such customers. For example, the constitution of the Pacific Coast Exchange stated as follows:

> "Commissions shall be charged and collected by members and member firms upon the execution of all orders involving the purchase or sale of securities admitted to dealings on the Exchange for the account of others. Commissions shall be charged and collected pursuant to rules and regulations prescribed by the Board of Governors and shall be at rates not less than those established by said Board. Commissions shall be net and free from any rebate, return, discount or allowance in any shape, manner, method or arrangement direct or indirect."

* * *

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* Plaintiffs' claims concerning recapture of stock exchange commissions relate only to the period of minimum commissions because where commissions are negotiated there is nothing left to recapture.

> "A member or member firm proposing or offering to transact business at rates less than the minimum commission rates established by the Board of Governors or in a manner designed to avoid or evade commission rules and regulations prescribed by the Board shall be deemed to have violated this Constitution."*

The recapture of any part of a commission by a customer would obviously be inconsistent with this rule absent some specific language in an exchange's constitution or rules exempting that kind of procedure. The rules of the PBW expressly permitted NASD members to receive customer-directed give-ups prior to December 5, 1968 (127a). The rules of the Pacific Stock Exchange also permitted NASD members (who became "preferred rate non-members") to receive such give-ups (222a, 215a-216a). However, there was nothing in any of these rules which expressly allowed an NASD member to rebate such give-ups to a mutual fund or any other customer in violation of the anti-rebate rules. Nor was there any reason to read any implied exception into the anti-rebate rules permitting such "NASD recapture".

The obvious purpose of permitting NASD members to share in commissions was to give bona fide professional brokers and dealers access to the regional exchanges and to encourage NASD members and mutual funds to bring

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* Constitution, Art. XIV, §§ 1, 4, CCH PACIFIC COAST STOCK EXCHANGE GUIDE ¶¶ 1826, 1846 (1975). Since stock exchange rules have the force of law (see text at pp. 23-25 *infra*), the Court may take judicial notice of them, just as it may take judicial notice of the regulations of any other regulatory agency. The PBW anti-rebate rule is in the appendix at 125a.

trades there.* There is nothing in any of the rules to suggest that they were designed to permit mutual funds to pay lower net commissions than other customers and thereby undermine the basic commission structure. Consequently, anyone reading the rules of the exchanges had to assume that NASD recapture was inconsistent with them.

NASD recapture was also inconsistent with the Maloney amendment of the 1934 Act and the rules of the NASD enacted pursuant thereto. The Maloney amendment was designed to bring brokers and dealers who were not members of exchanges within the ambit of SEC supervision on a basis similar to that applicable to exchanges. 52 Stat. 1070 (1938), 15 U.S.C. § 78o-3. Pursuant to the statute, the NASD must have rules which are

> "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; *and are not designed to permit unfair discrimination between customers* or issuers, or brokers or dealers. . . ." 15 U.S.C. § 78o-3(b)(8) (emphasis added)

It would have been inconsistent with the congressional purpose for NASD members to discriminate in favor of mutual funds and against other large or small investors by engaging in NASD recapture of give-ups.

Plaintiff attempted to meet these points by offering evidence that NASD officials and officials of some regional

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* *See* pp. 21-2 *infra* and Ex. 4 at p. 156 n. 13.

exchanges nevertheless interpreted their rules so as to permit, or otherwise tolerated, recapture by mutual funds and that this somehow made such rebates lawful. There are three answers to this.

First, there is nothing in the record to show that during the relevant period NASD or any exchange published or filed with the SEC any constitutional amendment, rule, or policy interpretation permitting the "recapture" of give-ups. It is fundamental that "the 'law' should be as visible, identifiable, and certain as we can contrive to make it." *De Renzis* v. *Levy,* 297 F. Supp. 998, 1001 (S.D.N.Y. 1969) (Frankel, J.). To the extent that a fund manager may be "guilty . . . of gross misconduct or gross abuse of trust"* or "a breach of fiduciary duty involving personal misconduct"** — or any other actionable dereliction of duty — for failure to utilize stock exchange rules or interpretations favorable to mutual funds, "this could only be true if, at a minimum, the propositions in question were promulgated, recorded, and known as rules — or, at least, something closely approximating rules." *Ibid.* When a mutual fund manager or his legal counsel wants to find out what the rules of a stock exchange permit and forbid, he should be entitled to rely upon the published rules of that stock exchange. If the published rules say "black" it should be immaterial that a stock exchange official has issued his private opinion to a third person that "black" is really "white."

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* 15 U.S.C. § 80a-35 prior to December 14, 1970 (§ 36 Investment Company Act).

** 15 U.S.C. § 80a-35(a) after December 14, 1970 (§ 36(a) Investment Company Act).

Second, the power to interpret the constitutions of the PBW and Pacific stock exchanges has been vested in their boards of governors throughout the relevant period.* Nothing in the record indicates that the board of governors of either the Pacific or PBW exchanges passed upon any alleged interpretations privately issued by officers of those exchanges and relied upon herein by plaintiff or that such interpretations were made known to defendants.

Third, even if the boards of governors had issued such interpretations, they would have been void. Although the stock exchanges have some authority to formulate, apply and interpret their own rules, there are limitations. An exchange rule which has not been enacted in a manner authorized by the exchange's own constitution or one which is "contrary to law or to public policy" will be held invalid. C. MEYER, THE LAW OF STOCKHOLDERS AND STOCK EXCHANGES, § 7, at 82-3 (1931). A stock exchange may not apply its rules in an arbitrary fashion, *Silver* v. *New York Stock Exchange,* 373 U.S. 341 (1963), nor will the board of governors be permitted by a court to interpret the exchange's constitution in a way unsupported by that document's clear and unambiguous language, *Bright* v. *Philadelphia-Baltimore-Washington Stock Exchange,* 327 F. Supp. 495, 504 (E.D. Pa. 1971). If an exchange could amend an exchange rule through a private interpretation which is not filed with the SEC and which is contrary to its express language and apparent purpose, the requirement of the Exchange Act that exchange rules be filed with the SEC and that exchanges be subject to SEC supervision would be effectively frustrated.

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* *See* Constitution, Pacific Coast Stock Exchange, Art. XVII, § 2, CCH PACIFIC COAST STOCK EXCHANGE GUIDE ¶ 1981; By-Laws, PBW Stock Exchange, Art. IV, §§ 4-17, CCH PBW STOCK EXCHANGE GUIDE ¶ 1092 (formerly Const., Art. III, § 21).

Any doubt that "NASD recapture" of give-ups was in direct contradiction to the language of both exchanges' constitutions which prohibit "any rebate, return, discount or allowance in any shape, manner, method or arrangement direct or indirect", *supra* at p. 5, is dispelled by a reading of cases interpreting similar anti-rebate provisions in analogous contexts.

The Insurance Law of New York contains strict anti-rebate provisions with regard to premiums. N. Y. INSURANCE LAW §§ 188, 209, 273 (McKinney's 1966). In *Arcim Corporation* v. *Pink,* 253 App. Div. 428, 2 N.Y.S. 2d 709 (3d Dep't 1938), *aff'd,* 280 N.Y. 721, 21 N.E. 2d 213 (1939), the court construed this statute which at that time read in pertinent part:

> "nor shall any insurance broker . . . directly or indirectly, . . . in any manner whatsoever pay or allow . . . to the insured named in such policy . . . as inducement to such insurance, or after the insurance shall have been effected, any rebate from the premium which is specified in the policy; nor shall the insured, . . . directly or indirectly accept or knowingly receive any such rebate from the premium specified in the policy." Insurance Law § 65, quoted at 253 App. Div. at 429.

In *Arcim,* the plaintiff, a corporation licensed as an insurance broker, which was wholly owned by the trustees of certain first mortgage certificates of a title and mortgage company in default, sought a declaration that it would not be in violation of the law if it were to act as broker and receive commissions in securing insurance policies in which the named assureds are the trustees or a corporation wholly owned by them. The Court said:

"First it is to be observed that the trustees are here seeking to save for their beneficiaries a portion of the cost of insurance on the properties being administered by them under their trust. The method used by them is a wholly owned corporation, which will receive commissions on the insurance it brokers and then pass these commissions back to the trustees in the form of dividends on its capital stock. Thus the net result of the transaction is a saving to the insured on insurance premiums. The plaintiff urges that this it may legally do because it is a legal entity separate and distinct from the insureds and that the dividends on its stock are returns on the capital invested by its stockholders. But call it what you will, the net result is that the insureds, through the circuitous route of their corporation, are receiving their insurance at less than the premiums specified in their policies . . . The use of the separate corporate entity to accomplish the same result is merely effecting it by indirection instead of directly. The statute forbids the practice, when accomplished either directly or indirectly.

* * *

"If these trustees may do what they seek here, then any property owner may form an insurance brokerage corporation and thus procure his insurance at less than the premium specified in the policy. This is not a case of insurance being placed incidentally by an insurance brokerage corporation on property of one of its stockholders, and some small portion of the broker's commission coming back to the insured as dividends. It is no mere insignificant or unintentional occurrence. Stripped of its non-essentials the transaction is in substance a rebate from the premium. This the statute forbids." 253 App. Div. at 429-30.

Nor can the anti-rebate provisions of the Insurance Law be evaded by the broker charging the full commission on the insurance, but reducing or eliminating his fee for another service which his customer also utilizes. The Attorney General of New York was presented with just this proposition:

> ". . . You state that life insurance agents making a study of pension plans as advisers to corporations, in most circumstances receive a stated fee for such service. If the plan they devise is accepted and a policy is written by them as agent for a life insurance company, they also earn commission on the policy. The question you have is whether the life insurance agent may waive his fee for advising on the pension plan if he writes the policy as agent for a life insurance company." (1946 Opinions of the Attorney General 230 (June 17, 1946)).

He concluded that the waiver of the fee for advising on the pension plan would violate Insurance Law § 209.

> "By the waiver of such fees, the corporation receives what amounts to a rebate. . . .
>
> "Through the practice you cite of waiving the fee for the pension study, the rebate comes to the corporation indirectly. But the result accomplished indirectly is within the specific prohibition of the statute, just as a direct rebate is." *Id.* at 231.

In the federal courts, the most frequently interpreted anti-rebate provisions are those contained in the Interstate Commerce Act, 49 U.S.C. §§ 2, 10, and the Elkins Act which was passed in 1903 and amended in 1906 by the Hepburn Act for the purpose of preventing any downward deviations from published rates regardless of whether discrimination

among customers can be proved. 49 U.S.C. § 41. The variety of ingenious schemes devised by persons who would evade the language and purposes of these anti-rebate provisions is almost endless. Such schemes, frequently involving the provision of goods or services other than transportation at prices below market value or gratis or the creation of dummy corporate entities, have invariably been struck down by the courts.*

The only judicial authority which plaintiff can cite for the proposition that NASD recapture was lawful is the Court of Appeals opinion in *Moses v. Burgin,* 445 F.2d 369, 374 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971). That case is of doubtful validity as authority for the legality of NASD recapture because defendants in that case, who had admittedly engaged in the practice to a substantial extent (and so presumably had not believed they were acting unlawfully) may have found it rather awkward to be arguing later that they could be held liable for so doing. Nevertheless, Judge Wyzanski held in the district court that NASD recapture would violate the anti-rebate rules of regional exchanges and hence be unlawful. After identifying such recapture devices as "rebates", he said:

> "... They are forbidden by the text and the policy of the minimum commission structure and anti-

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* *See, e.g.,* Union Pacific R.R. Co. v. United States, 313 U.S. 450 (1941); Baltimore & Ohio R.R. Co. v. United States, 305 U.S. 507 (1939); United States v. P. Koenig Coal Co., 270 U.S. 512 (1926); Fourche River Lumber Co. v. Bryant Lumber Co., 230 U.S. 316 (1913); United States v. Union Stock Yard & Transit Co., 226 U.S. 286 (1912); New York, New Haven & Hartford R.R. Co. v. Interstate Commerce Commission, 200 U.S. 361 (1906); Spencer Kellogg & Sons, Inc. v. United States, 20 F.2d 459 (2d Cir. 1927); Northern Central Ry. Co. v. United States, 241 Fed. 25 (2d Cir. 1917); Vandalia R. Co. v. United States, 226 Fed. 713 (7th Cir. 1915); United States v. Milwaukee Refrigerator Transit Co., 145 Fed. 1007 (E.D. Wis. 1906); Interstate Commerce Commission v. Reichmann, 145 Fed. 235 (N.D. Ill. 1906).

rebate rules, of which Article XV, section 1 of NYSE (quoted in the findings of fact) is the prototype. Those devices have the evil consequence of giving back to the customer a dollar credit traceable directly or indirectly to the commission he paid.

> "Inasmuch as an anti-rebate rule is the type of stock exchange rule which has the force of law and is binding alike upon members and customers of the exchange (*Silver v. New York Stock Exchange*, 373 U.S.341, 360-361, 83 S.Ct. 1246, 10 L.Ed.2d 389; *Colonial Realty Corporation v. Bache & Co.*, 358 F.2d 178, 181-182 (2d Cir.)) all recapturing devices which are contrary to the anti-rebate provisions of exchange constitutions are illegal." 316 F. Supp. 31, 57 (D. Mass. 1970)

The contrary reasoning of the Court of Appeals on this point was as follows: Give-ups directed by mutual fund customers and not recaptured are also a form of rebate since they are indirectly beneficial to the fund in that they help promote sales of fund shares and reward those who supply research information. Since rules of some exchanges expressly permitted this form of remote and indirect "rebate", exchange officers were free to interpret the rules also to permit direct and immediate rebates of hard cash. 445 F.2d at 382.

This reasoning was fallacious because the court lost sight of the obvious purposes of the anti-rebate rules which were to prevent the undermining of the basic minimum commission structure and to prevent unjust discrimination among customers. In the case of a customer directed give-up which was not recaptured, the money went not to the investment company or its adviser but to another member of the brokerage community. Hence the basic commission structure was not seriously undermined and there was no harm-

ful discrimination. Moreover, there were specific provisions in regional exchange rules authorizing the practice of directing give-ups to *other brokers*. NASD recapture, on the other hand, would have rendered the anti-rebate rules meaningless, made a mockery of the basic commission structure, and discriminated unjustly in favor of mutual funds as against other customers. The Court of Appeals opinion, which has been narrowly construed by several district judges in this Circuit and by Judge Freedman in the District of Massachusetts, and substantially rejected by Judge Carter in a very recent case (see p. 42, *infra*), should have no application here and should not be accepted by this Court especially in view of the serious legal consequences which, as we show in Part D below at pp. 24-33 *infra*, might have resulted if defendants had engaged in NASD recapture.

The SEC publications referred to by plaintiff also provide no basis for assuming that NASD recapture was lawful. The particular sentence* relied upon by plaintiffs which they construe as authority for the legality of NASD recapture of give-ups appeared first in December 1966 at page 173 of a staff study, 346 pages in length, entitled *Public Policy Implications of Investment Company Growth*** ("PPI"). This double negative remark is not persuasive authority in support of NASD recapture because from the context in which it appears (Ex 4 at 147a) it is doubtful that the writer had considered the anti-rebate rules which on all exchanges would have forbidden such a scheme. As Judge Wyzanski said:

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* "It would not be inconsistent with those rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds."

** Ex. 4; H. R. Rep. No. 2337, 89th Cong., 2d Sess. (December 2, 1966).

"That statement was not buttressed by any legal analysis or precedent. No mutual fund or its underwriter had used such a device up to the time of the report.

"Moreover, that statement was in direct conflict with the text of, the policy of, and the then practice under the anti-rebate rules of every exchange." 316 F. Supp. at 45.

Because of its lack of significance in connection with the main points made in the PPI Report as a whole, the sentence could hardly be regarded as a considered view of the SEC Commissioners and in that sense is analogous to the weakest of dicta. That portion of the report which dealt with give-ups and commissions paid by mutual funds on stock exchange transactions recognized that give-ups were the inevitable result of a rigid commission structure which resulted in commission rates which were too high on large transactions.* It also noted that give-ups had been abused in some cases, for example, by "churning" and "interpositioning".** Its main thrust was the recommendation that quantity discounts be instituted for all customers, not just mutual funds. Its further recommendation that give-ups be abolished was closely linked to the quantity discount recommendation, thereby confirming that the Commission was concerned about give-ups primarily because they were a symptom of the fact that rates were too high on large orders and incidentally that give-ups had been subject to abuse.***

The PPI Report also made a number of other major recommendations regarding the mutual fund industry hav-

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* Ex. 4, pp. 156-58, 185.

** Ex. 4, pp. 174-75, 178. There is no evidence of any such abuse in this case.

*** Ex. 4, p. 187.

ing nothing to do with this case. No suggestion that mutual funds should engage in NASD recapture in order to obtain rates lower than other customers appears among the recommendations made in the report. Any such recommendation would have been inconsistent with the mandate of the Maloney amendment that NASD rules avoid unfair discrimination (p. 6, *supra*). It would also have been inconsistent with the basic recommendations that quantity discounts be introduced for all customers and that give-ups be abolished.

The PPI Report did not depart from earlier SEC reports which recognized that customer-directed give-ups were the logical and appropriate response to the fact that minimum commission rates paid by large investors were too high. For example, in the *Report of Special Study of Securities Markets of the Securities and Exchange Commission,* H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) (''*Special Study*''), the Commission said:

> ''[S]o long as the present [minimum rate] structure exists, there is no impropriety in directing the benefits of reciprocity to beneficiaries other than the funds, if the acquisition or use of these benefits does not in any way operate as a detriment to the funds and if the funds have themselves derived as much as they can from these benefits.'' *Id.,* part 4, at 214. See also 233-35; part 2, at 295-300, 936-38.

The 595-page ''Study of Mutual Funds,''* prepared at the request of Congress by the Wharton School of Finance and Commerce similarly concluded that give-ups were the ''consequence of a relatively inflexible structure of prices for brokerage services. . . .''

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* H. R. Rep. No. 2274, 87th Cong., 2d Sess. 539 (1962).

On January 26, 1968, about one year after the PPI Report, the SEC issued Securities Exchange Act Release No. 8239 (252a-264a) which contained two alternative proposals, a tentative proposal by the SEC, known as proposed rule 10b-10, and a plan put forward by the New York Stock Exchange, both of which dealt with give-ups and commission rates. In support of the tentative SEC proposal, which was put forth rather gingerly (see 252a, fourth and fifth paragraphs), the release repeated the sentence on NASD recapture from the PPI Report relied upon by plaintiffs but again did not support it with any authority. The tentative SEC proposal was soon abandoned by the SEC and on December 5, 1968 at the urging of the SEC all stock exchanges adopted substantial quantity discounts in their respective minimum commission structures and, at the same time, completely abolished customer-directed give-ups. *See* [1967-69] CCH Fed. Sec. L. Rep. ¶¶ 77,585, 77,599.

One of the reasons for the abandonment of the tentative SEC proposal and the sentence supporting it may have been the Commission's basic recognition that it was inconsistent with its basic desire to reduce commission rates for all customers. Another may have been the reaction of the Department of Justice which attacked the SEC proposal as being unduly discriminatory as against other large investors. *See Selected Comments on SEC Proposed Rules on Give-ups and NYSE Proposal on Commission Rules,* CCH Fed. Sec. L. Rep., Extra Edition No. 198, at 27 (May 3, 1968).

Forcing the exchanges to adopt quantity discounts was merely the first step in the SEC's drive to abolish all minimum commission rules. In 1971, after extended public discussion, the exchanges were required to permit negotiated commissions on trades involving securities worth more than $500,000. In the following year this amount was reduced to $300,000 and on May 1, 1975 negotiated rates be-

came effective for all trades. *See* Securities Exchange Act Release No. 11203 (Jan. 23, 1975), [1974-75] CCH Fed. Sec. L. Rep. ¶ 80,067.

Taken in the context of this history, the unsupported suggestion that NASD recapture might be consistent with some stock exchange rules was not worthy of serious consideration as authority for the validity of such practices, especially in view of the consistent judicial condemnation of discriminatory rebate schemes designed to evade fixed rates in regulated industries (*see* pp. 9-12, *supra*). Indeed, if anything, the above history of the SEC's approach to the subject of quantity discounts and give-ups tends to confirm that the practice of NASD recapture of give-ups was at very best of doubtful legal validity.

B. Acting as an "Introducing Broker" on the PBW or Pacific Coast Exchange Solely for the Purpose of Recapture Was Unlawful

In this section, as previously noted, we do not discuss whether it would have been lawful for defendants to form an affiliate which would actually engage in the public brokerage business and become a bona fide member of an exchange. Here we are only concerned with the use of a dummy affiliate which would become a member of PBW or a "preferred rate non-member" of the Pacific Coast Exchange and receive portions of commissions on fund transactions executed there and rebate them to the fund merely for "introducing" the fund to a bona fide broker member of the exchange who would actually execute and clear the transaction and assume all of the usual obligations of a bona fide broker.

In asserting that this form of recapture was lawful on PBW, plaintiffs rely on the testimony of its president, Wetherill, to the effect that his exchange would tolerate

having institutions obtain and use membership solely for the purpose of recapture by this method.

His position is not consistent with the rules of his exchange. For example, Section 2 of Article XIII* of the By-laws of the PBW Exchange states with respect to member corporations that "[o]nly a corporation whose principal corporate purpose is the transaction of business as a broker or dealer in securities may be registered as a member corporation"; Article I, Section 1(c)** contains a similar restriction applicable to partnerships. Judge Wyatt's reasoning (338a) with respect to NASD membership is equally applicable to membership on the PBW. Acquisition of PBW membership without engaging in the brokerage business would have been just as much a sham as joining the NASD. And of course preferred rate non-membership could not be obtained on the Pacific Exchange without obtaining NASD membership (216a; 221a).

Moreover, use of the PBW Exchange as a dummy "introducing broker" solely for purposes of recapture would have been just as inconsistent with its anti-rebate rule as NASD recapture of give-ups and just as unlawful (see Part A, *supra*). As Judge Bricant noted, acquisition of membership on the New York Stock Exchange by a dummy broker affiliate for the purpose of recapture necessarily results in a violation of the Exchange's anti-rebate rules, *Robert W. Stark, Jr. Inc.* v. *New York Stock Exchange,* 346 F. Supp. 217, 226 (S.D.N.Y.), *aff'd without discussion of this point,* 466 F.2d 743 (2d Cir. 1972).

Plaintiffs' assertion that approximately 50 institutions had affiliates which became members of PBW is interesting

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* CCH PBW Stock Exchange Guide ¶ 1302.

** CCH PBW Stock Exchange Guide ¶ 1001.

only because the number is such a tiny fraction of the total universe of thousands of large insurance companies, pension funds and other institutional investors which might have been interested in any lawful method for reducing their brokerage costs. Moreover, that assertion is misleading since there is no evidence in the record that any significant number of the 50 affiliates were dummies.* Even if this were assumed to be true, it would still prove nothing since the existence and toleration of some dummy brokers is no justification for holding that it would have been lawful for defendants to have acted similarly. It is not lawful to exceed the speed limit merely because others do so.

Plaintiffs rely on the testimony of Phelan, president of the Pacific Coast Exchange and a letter written by him to another mutual fund (224a-225a) for the proposition that defendants could have established a dummy broker to become a member of NASD, thereby allegedly qualify as a preferred rate non-member of the Pacific Exchange and by virtue of such status receive portions of commissions on Fund transactions executed thereon by a bona fide full member of the exchange and rebate them to the Fund. Assuming, contrary to Judge Wyatt's conclusion, that this dummy broker could qualify for NASD membership, the evidence still does not support plaintiffs' position. The letter relied upon by the plaintiffs makes it clear that a preferred rate non-member was required to sign an application for such status in which he agreed that he would

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* In fact, according to the PBW's statements before Congress, most institutionally-affiliated members were bona fide brokers who dealt with the general public, many of whom did no business at all for affiliated accounts. *Study of the Securities Industry, Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce,* 92d Cong., 2d Sess., part 7, at 3694, 3779, 3831-32 (1972); *Securities Industry Study, Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs,* 92d Cong., 1st Sess. part 1, at 224. (1971)

> "not directly or indirectly extend or grant the Preferred Commission Rate to another not approved by the Exchange to receive such rate."

The "introducing broker" scheme proposed by plaintiffs would be inconsistent with this sentence and would also violate the antirebate rule of the Pacific Exchange (see Part A, *supra;* and *Robert W. Stark, Jr. Inc.* v. *New York Stock Exchange, supra*).

The rule of the Pacific Exchange relied upon by plaintiffs was really an access rule designed to compensate bona fide non-member brokers who introduced business to exchange members. In 1972, at the urging of the SEC, all exchanges adopted access rules providing that bona fide non-member brokers could receive 40% of the regular stock exchange commission on transactions they originated. On all exchanges these rules included provisions preventing use of them as recapture devices. In 1973, at the time it adopted Rule 19b-2 prohibiting institutional membership, the SEC also discussed access rules generally and characterized preferred rate non-member recapture devices on certain exchanges as "inappropriate uses" of the preferred rate non-member rules. Ex. L, Securities Exchange Act Release No. 9950, CCH Fed. Sec. L. Rep. No. 460 at 182 (1973). It also stated with respect to the newer 40% access rule that it

> "was never intended to enable any individual customer to obtain a commission rate advantage . . ." *Id.* at 183n 519.

Plaintiff's whole theory here is erroneous because it would have required defendants to act contrary to this policy.

Plaintiffs cite several authorities claimed to "bless" the joining of exchanges by affiliates of mutual funds. None of them focuses on the problems raised where the proposed member is a dummy which acts only as an "introducing

broker" and hence none supports the claim for legality of plaintiffs' "introducing broker" scheme for recapture.

C. NASD Recapture of Tender Offer Fees was Unlawful

Even if it be assumed, contrary to Judge Wyatt's holding, that NASD membership was available to defendants, NASD recapture of tender offer fees during the period involved in this complaint would have violated Article III, Section 24, of the Rules of Fair Practice of NASD, which provides that

> "selling concessions, discounts, or other allowances, as such, shall be allowed only as consideration for services rendered in distribution and in no event shall be allowed to anyone other than a broker or dealer actually engaged in the investment banking or securities business; . . ." *See* Exhibit 21.

Judge Wyzanski so held in *Moses* v. *Burgin*, 316 F. Supp., *supra,* at 47-8, and this holding was not disturbed on appeal.

Such illegality was also established by the Williams amendment to the Securities and Exchange Act of 1934 (82 Stat. 455 (1968); 15 U.S.C. § 78n(d)(7)), which prohibits price discrimination among holders of securities who sell to the offeror during the period of a tender offer as follows:

> "Where any person varies the terms of a tender offer or request or invitation for tenders before the expiration thereof by increasing the consideration offered to holders of such securities such person shall pay the increased consideration to each security holder whose securities are taken up and paid for pursuant to the tender offer or request or in-

> vitation for tenders whether or not such securities have been taken up by such person before the variation of the tender offer or request or invitation."

In 1969, the SEC promulgated Rule 10b-13 (17 C.F.R. § 240.10b-13 (1975)), which contains a similar prohibition as follows:

> "(a) No person who makes a cash tender offer or exchange offer for any equity security shall, directly or indirectly, purchase, or make any arrangement to purchase, any such security . . . otherwise than pursuant to such tender offer or exchange offer from the time such tender offer or exchange offer is publicly announced or otherwise made known by such person to holders of the security to be acquired until the expiration of the period, including any extensions thereof, during which securities tendered pursuant to such tender offer or exchange offer may by the terms of such offer be accepted or rejected . . ."

In 1972, the SEC proposed a rule which would have expressly prohibited NASD recapture of tender offer fees and explained its rationale for it as follows:

> "The Commission believes that certain inequities and hardships result to tendering public shareholders if some shareholders, by virtue of special position or economic power, are able to receive, directly or indirectly, compensation beyond the tendering price generally offered to shareholders. . . . It is inconsistent with these goals to permit tender offerors or exchange offerors to compensate certain shareholders with consideration greater than or different from that generally being offered other shareholders." Securities Exchange Act Release No. 9920,

[1972-73] CCH Fed. Sec. L. Rep. ¶ 79,156, at 82,517 (December 27, 1972).

In April 1973 the SEC retreated from this position and issued the release cited on page 40 of Plaintiffs-Appellants' brief. Contrary to plaintiff's explanation of this release, it did not state that such commissions *must* be recaptured but only that a fund manager "*may* have an obligation to name an affiliated broker to receive" them. (emphasis added) [1973] CCH Fed. Sec. L. Rep. ¶ 79,327, at 83,000. Certainly no lawyer could assume before the publication of this release that a fund could recapture tender offer fees with safety. Even after the release a fund might not be safe from private suits under the Williams Act, *supra,* unless it obtained a specific ruling from the SEC pursuant to Section 23(a) of the Securities and Exchange Act of 1934 (15 U.S.C. § 78w(a)) permitting it to recapture such fees and thereby obtain a higher net price than other shareholders.

This vacillation by the SEC on the legality of tender fee recapture within a period of only four months is illustrative of that agency's difficulty in coming to grips with the subject of recapture and demonstrates that it would have been impossible for prudent counsel to conclude with confidence that any of the plaintiffs' schemes for recapture was lawful.

D. Use of Plaintiffs' Recapture Schemes Might Have Resulted in Serious Legal Consequences

Below we list some of the possible ways in which plaintiffs' recapture schemes might have caused serious legal problems for an investment company or its advisers:

(1) *Liability Under the Securities Exchange Act.* There is no doubt that violations of various sections and rules promulgated under the Securities Exchange Act of 1934 can often result in civil liability. Following Judge Friendly's discussion in *Colonial Realty Corp.* v. *Bache & Co.*, 358 F. 2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966), of whether a cause of action lies against a stock exchange member for violation of stock exchange and NASD rules, it has generally been held that such an action lies in a number of different circumstances. *Van Gemert* v. *Boeing Company*, CCH FED. SEC. L. REP. ¶ 95,234, at 98,232 (2d Cir. 1975); *Ocrant* v. *Dean Witter & Co.*, 502 F. 2d 854 (10th Cir. 1974); *Buttery* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* 410 F. 2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); *Starkman* v. *Seroussi*, CCH FED. SEC. L. REP. ¶ 94,600 (S.D.N.Y. 1974) (Weinfeld, J.) (under §§ 6, 19 and 27). A fund and its adviser might have been liable as members of any exchange upon which they recaptured commissions even without actually joining the exchange. Section 3(a)(3) of the Exchange Act provides that any person who "is permitted . . . to make use of the facilities of an exchange for transactions thereon . . . with the payment of a commission or fee which is less than that charged the general public . . ." is a "member" of the exchange for purposes of the Act.*

Liability for violation of exchange rules is not limited to members only. Under fundamental legal principles, a nonmember entitled to a discount from the public rate would be assumed to have tacitly agreed to adhere to the rules

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* *See also Special Study, supra* at pp. 18-19, part 2, at 299 n. 543.

of the exchange, *Crowley* v. *Commodity Exchange, Inc.*, 141 F. 2d 182, 188 (2d Cir. 1944). The same is true of a customer, *Bibb* v. *Allen,* 149 U.S. 481 (1893). Consequently, the fund or its adviser might be regarded as an aider and abettor of, or conspirator with, any stock exchange member who yielded commissions knowing that they were to be used as improper rebates. *SEC* v. *Spectrum, Ltd.*, 489 F. 2d 535, 541 (2d Cir. 1973); *Odette* v. *Shearson, Hammill & Co.*, [1974-75] CCH Fed. Sec. L. Rep. ¶ 95,038, at 97,639-41 (S.D.N.Y. 1975); Restatement of Torts § 867. Moreover, by analogy to other Federal anti-discrimination statutes, the recipient, as well as the grantor, of a discriminatory benefit is subject to suit. See *Hartley & Parker, Inc.* v. *Florida Beverage Corp.*, 307 F. 2d 916 (5th Cir. 1962); *State Wholesale Grocers* v. *Great Atlantic & Pacific Tea Co.*, 258 F.2d 831 (7th Cir. 1958), *cert. denied,* 358 U.S. 947 (1959). Consequently, both the fund and the adviser might be subject to the same liability as a full exchange member for violation of anti-rebate rules.

Since NASD rules were adopted under a statutory scheme similar to that applicable to stock exchange rules, they also have the force of law. Consequently violations of the NASD rules might also give rise to private causes of action.

Who might have brought suit for violations of the anti-rebate or other stock exchange or NASD Rules? Persons who were injured by the unlawful discrimination resulting from the violation of the anti-rebate rule. *Cf. Bruce's Juices, Inc.* v. *American Can Co.*, 330 U.S. 743, 757 (1947). This could include anyone who paid the full commissions and did not receive rebates, including other mutual funds,

fund managers and other institutions not properly entitled to NASD membership, and private investors. Possible plaintiffs might also include any exchange member which failed to get the fund's portfolio business because it would not agree to participate in the fund's recapture schemes.

(2) *Unenforceable Contracts.* In *Roberts* v. *Criss,* 266 Fed. 296, 300-1 (2d Cir. 1920), this Court made a common law holding that a contract involving the violation of a stock exchange rule is illegal and unenforceable by a non-member party to the contract who knew of the rule. In *Kamen & Co.* v. *Paul H. Aschkar & Co.,* 382 F2d 689 (9th Cir. 1967), *cert. dismissed,* 393 U.S. 801 (1968), a broker who was not a member of any stock exchange brought suit against a member of two exchanges for the amount paid for certain worthless stock alleged to have been purchased because of fraudulent conduct by defendant's agents in transactions which violated exchange anti-rebate rules. In holding that the agents of the defendant did not have ostensible authority to make the representations for which plaintiff sought to hold defendant liable, the Court of Appeals noted that plaintiff, though not a member of either stock exchange,

> "was aware of the fact that both Exchanges had rules prohibiting the giving of rebates, returns, or discounts or allowances in return for listed business, a violation of which could result in disciplinary action against the member by the Exchange." *Id.* at 696.

The judgment of the trial court in favor of plaintiff was therefore reversed and the cause remanded with instructions to enter judgment for defendant on the ground that

the contract made in violation of the anti-rebate rule was invalid.* *Id.* at 698.

It follows that neither the fund nor its manager may have been in a position to enforce the fund's rights under any contract involving recapture. If the manager's advisory fee contract with the fund provided for the reduction of advisory fees by an amount equivalent to commissions received on fund transactions, the entire contract might have been held void and the manager might have had no remedy if the fund, perhaps at the insistence of a shareholder, declined to pay it any advisory fee at all. Similarly, if the fund, or the manager acting for the fund, had placed orders with an exchange member on the understanding that a portion of the commissions was to be rebated to the fund, the fund might have lost all of its remedies against the exchange member for failure to deliver or pay for securities or for delivering counterfeit or stolen securities.

(3) *Sherman Act Liability.* In *Gordon* v. *New York Stock Exchange*, 498 F. 2d 1303, 1310 (2d Cir. 1974), *aff'd* 43 USLW 4958 (1975) it was recently held that there is an implied exemption from the antitrust laws which permits stock exchanges to maintain a minimum commission structure and that this exemption logically must also apply to anti-rebate rules designed to protect such a structure because the SEC has always had authority to order changes in

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* The common law rule of these cases may have been incorporated, at least in part, into Federal law in Section 29(a) of the Securities Exchange Act, 15 U.S.C. § 78cc(a), which provides:

> "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby, shall be void."

such rules. However, the Supreme Court appeared to leave open the question whether a discriminatory application of an anti-rebate rule would fall within the exemption, 43 U.S.L.W. at 4966. In *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963), the Supreme Court made it clear that an arbitrary application of stock exchange rules would not fall within the exemption where the SEC had no opportunity to review it. This Court recently suggested that the exemption should not apply where the conduct complained of was not necessary to make the self-regulatory system work and where it was not consistent with the rule of reason, *Jacobi* v. *Bache & Co., Inc.*, CCH Fed. Sec. L. Rep. § 95,253 (2d Cir. 1975). Under these tests a conspiracy between stock exchange customers and exchange members and officers to confer discriminatory rebates upon selected customers without obtaining the express approval of the SEC* or without even filing amendments or interpretations of exchange rules authorizing such conduct might well be held to be outside the exemption. If so, recapture might subject defendants and the Fund to treble damages for violations of the Sherman Act.

(4) *Liability for Unlawful Brokerage Under Section 2(c) of the Robinson-Patman Act.* Plaintiff is not the first person to concoct the idea of the dummy broker-affiliate created only to obtain rebates. Congress became concerned with such practices in the 1930s and enacted Section 2(c) of the

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* Where immunity from the antitrust laws is dependent upon making filings with a public agency with a procedure for review, strict compliance with the filing requirements is necessary. *See* Carnation Co. v. Pacific Westbound Conference, 383 U.S. 213 (1966).

Robinson-Patman Act, generally referred to as the "brokerage clause".*

The brokerage clause was intended to make it unlawful per se for any unearned commission to be paid to the other party to a transaction or his agent. Speaking for the Court in *Federal Trade Commission* v. *Henry Broch & Co.*, 363 U.S. 166, 169 (1960), Justice Douglas said:

> "One of the favorite means of obtaining an indirect price concession was by setting up 'dummy' brokers who were employed by the buyer and who,

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* "It shall be unlawful for any person engaged in commerce, in the course of such commerce, to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods, wares, or merchandise, either to the other party to such transaction or to an agent, representative, or other intermediary therein where such intermediary is acting in fact for or in behalf, or is subject to the direct or indirect control, of any party to such transaction other than the person by whom such compensation is so granted or paid." 15 U.S.C. § 13(c).

** Explaining this provision to Congress, Senator Logan said:

> "In order to evade the provisions of the Clayton Act, however, it was found that while direct price discrimination could not be indulged in, the buyer, if he were sufficiently powerful, could designate someone and say, 'That is my broker.' Perhaps it was a clerk in his office. Perhaps it was a manager of a store. Perhaps it was a subsidiary corporation organized for the purpose. However, the buyer would say to the seller, 'You must sell through that man, and you must pay him a certain percentage or amount of brokerage'; and when the so-called broker or dummy broker received what was paid him, he turned it over to the buyer, and in that way a price discrimination was brought about."
>
> "I undertake to say in this august body that there is not a Member of the Senate, there is not a Member of the House, who will not at once condemn a practice of that kind, which provides secret rebates under the guise of brokerage." 80 Cong. Rec. 6281 (April 28, 1936).

in many cases rendered no services. The large buyers demanded that the seller pay 'brokerage' to these fictitious brokers who then turned it over to their employer. This practice was one of the chief targets of § 2(c) of the Act. But it was not the only means by which the brokerage function was abused and Congress in its wisdom phrased § 2(c) broadly, not only to cover the other methods then in existence but all other means by which brokerage could be used to effect price discrimination."

Does Section 2(c) apply to dumy stockbrokers? It is well established that § 2(c) is independent of the rest of the statute, complete on its face, and that the defenses and qualifications applicable to § 2(a) do not apply to it.* Further, in reaching this result, the Courts have said that § 2(c) should be construed without regard to the rest of the statute.** Whereas § 2(a) applies to "commodities of like grade and quality," § 2(c) refers only to "services rendered in connection with the sale or purchase of goods, wares, or merchandise." Although "commodities" in the context of § 2(a) of the Robinson-Patman Act and Section 3 of the Clayton Act has been construed by some courts to refer only to "tangibles", there has been very little construction given to the term "services rendered in connection with the sale or purchase of goods" within the meaning of § 2(c) which so far as we know has never been held to

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* *See, e.g.*, Biddle Purchasing Co. v. Federal Trade Commission, 96 F.2d 687, 690 (2d Cir.), *cert. denied*, 305 U.S. 634 (1938); Quality Bakers of America v. Federal Trade Commission, 114 F.2d 393, 400 (1st Cir. 1940).

** *See, e.g.*, Great Atlantic & Pacific Tea Co. v. Federal Trade Commission, 106 F.2d 667, 675-77 (2d Cir. 1939), *aff'g* 26 F.T.C. 486, 509-12 (1938).

exclude brokerage services rendered in connection with the sale or purchase of securities.

In a variety of other contexts the term "goods" has been defined to include "stock".* Consequently, it is quite conceivable that § 2(c) of the Robinson-Patman Act might be applied to dummy brokers set up to recapture stock exchange commissions.

5. *Other Possible Adverse Consequences.* The condition which produced give-ups was the fixed commission structure which caused commissions on large trades to be too high. Mutual funds were only one of the groups of institutions which suffered as a result. Until this condition was corrected by the present system of negotiated commis-

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* *See* UNIFORM COMMERCIAL CODE, § 2-105; Steinthal v. Cohn, 22 A.D.2d 644, 252 N.Y.S.2d 977 (1st Dep't 1964) (Uniform Sales Act); Midwest Packaging Materials Co. v. Midwest Packaging Corp., 312 F. Supp. 134 (S.D. Iowa 1970) (stock certificates "goods" within meaning of Lanham Act, 15 U.S.C. § 1125(a).) The phrase "goods, wares or merchandise" has also been construed in other contexts to embrace corporate stock. *See, e.g.,* Coleman v. St. Paul & Tacoma Lumber Co., 110 Wash. 259, 268, 188 Pac. 532, 535 (1920); Hightower v. Ansley, 126 Ga. 8, 54 S.E. 939 (1906); Boardman v. Cutler, 128 Mass. 388, 390 (1880) (statutes of frauds).

In Banta v. City of Chicago, 172 Ill. 204, 50 N.E. 233 (1898), a city ordinance required any person acting in the capacity of a "broker" to pay a license fee. The ordinance defined a broker as "one who, for commission or other compensation, is engaged in selling or negotiating the sale of goods, wares, merchandise, produce or grain belonging to others." *Id.* at 235. The Supreme Court of Illinois held that this statute applied to stockbrokers saying:

> "the better and more firmly established doctrine is that, in the absence of any qualifying or restricting clause, the phrase 'goods, wares, and merchandise' includes and comprehends shares in the capital stock of incorporated companies, and other securities which are the subject of common barter and sale, and which are given visible and palpable form by means of certificates, bonds, or other evidences of indebtedness." *Id.* at 237.

sions, no one could tell what further legal consequences might result against those who used devious schemes to gain unfair advantages over other investors. Any mutual fund which engaged in the kind of recapture schemes suggested by plaintiff which appeared to be in direct violation of statutes, stock exchange rules or NASD rules had to assume that in any litigation involving such transactions it would be vulnerable to whatever further arguments, in addition to those suggested above, the ingenuity of counsel might suggest. Every experienced lawyer knows that his client's position may suffer in unpredictable ways if his client has apparently violated any statute, rule or regulation even remotely relevant to the issues being litigated and that the only safe course is scrupulous obedience to the letter and spirit of the law. In the present case the safe course was to refrain from plaintiff's proposed recapture schemes.

II.

THE DECISION BELOW SHOULD BE AFFIRMED IN ANY EVENT BECAUSE OF DEFENDANTS' RELIANCE UPON ADVICE OF COUNSEL

Plaintiffs' attack upon the evidence (see Def. — Appellees' Brief, pp. 14-23) that defendants relied upon the advice of counsel that recapture was legally impossible or dangerous is primarily based upon the contention that counsel were somehow disqualified from giving advice because they, directly or indirectly, owned shares in the Adviser and therefore had a conflict of interest.

However, in *Spirt* v. *Bechtel,* 232 F.2d 241, 247 (2d Cir. 1956), this Court held that reasonable reliance upon the advice of counsel insulates corporate officers and directors from liability even if the legal advice proves erroneous and even where such advice benefitted the officers and directors

and was to the apparent disadvantage of the corporation. Similarly, in *Blaustein* v. *Pan American Petroleum Transport Co.,* 293 N.Y. 281, 300, 56 N.E.2d 705, 713 (1944), minority shareholders of Pan Am, a subsidiary of Standard Oil of Indiana, brought suit against its officers and directors who were also officers and directors of Standard Oil. The defendants were held free of liability where they relied upon erroneous legal advice of one of their co-defendants, a Pan Am director who was also general counsel of Standard Oil, even though such advise benefitted Standard Oil to the detriment of Pan Am. Reasonable reliance on the erroneous advice of counsel also insulated corporate officers from liability in *Gilbert* v. *Burnside,* 13 A.D.2d 982, 983, 216 N.Y.S.2d 430, 432 (2d Dep't 1961), *aff'd,* 11 N.Y.2d 960, 183 N.E.2d 325, 229 N.Y.S.2d 10 (1962), *rev'g* 197 N.Y.S.2d 623, 633 (Kings Co. 1959).

Most recently, Judge Carter held, in *Tannenbaum* v. *Zeller,* CCH Fed. Sec. L. Rep. ¶ 95,257, at 98,335 (S.D.N.Y. July 30, 1975), that mutual fund directors may rely upon the advice of counsel that they need not recapture give-ups. These cases do not support plaintiffs' suggestion that the legal advice must be incorporated in a written memorandum.

Judge Wyatt did not make express findings on whether reliance on the advice of counsel in the present case was reasonable or whether the advice was given in good faith. On this record we submit that if this Court reaches this question it can and should make findings favorable to defendants on both of these points. If the Court nevertheless believes that there are factual issues on these points, they should be decided in the first instance by the lower court which saw and heard the witnesses. *See Schwartz* v. *Romnes,* 495 F.2d 844, 848 n.5 (2d Cir. 1974).

III.

DEFENDANTS HAD NO OBLIGATION TO RECAPTURE EVEN IF RECAPTURE HAD INVOLVED NO LEGAL PROBLEMS

Apart from the question whether recapture was unlawful or believed to be unlawful, there were sound business reasons why the directors of the fund could choose not to engage in plaintiffs' proposed recapture schemes. An obvious duty of the officers and directors of the Fund was to keep it alive. Since it was an open-end fund which undertook to redeem any shares presented to it (325a), it would have shrunk in size and soon disappeared in the absence of a compensating stream of sales of new shares. Only if the Fund continued could the stockholders share in the advantages of a mutual fund—diversified investment and professional management. Redemptions in excess of sales might have required the Fund to dispose of portfolio holdings at disadvantageous times and prices could otherwise have crippled the Fund's investment program.

Growth of the Fund through sale of Fund shares had an additional advantage for the shareholders as a result of the sliding scale by which the management fee was calculated (28a). As the size of the Fund increased, the management fee increased in size, but decreased per dollar invested in the Fund. Substantial size is necessary in order to permit any fund to employ the kind of qualified personnel necessary to maintain a good investment program.

Consequently, there is no doubt that the use of customer-directed give-ups and the placing of brokerage business so as to encourage brokerage houses to sell Fund shares was of substantial benefit to existing stockholders of the Fund and that the directors could opt for such use in the best

interests of the Fund. The fact that such use of brokerage was proper was attested to by the then Chairman of the SEC, Hamer H. Budge, who was interviewed as follows:

> [Q] "Would you consider it also a business decision for a mutual fund to use its commissions so as to promote the sale of its funds?"
>
> [A] "Assuming that they got the best execution, I don't see that the Commission should start telling people to whom they should take their business."*

Brokerage was also used by the Adviser to obtain useful research information for the Fund. There could be no doubt that the Fund's management had a duty to inform itself as to investments. The use of brokerage for this purpose was also approved by Chairman Budge as follows:

> [Q] "Do you think that it is justifiable for an institution to use commissions for any other purpose than getting an order executed as well as possible, say, for research?"
>
> [A] "I think that is a business decision. If the firm wants to use its resources for research, that is a bona fide operation. I don't know why we would question it."**

The PPI Report which indicated that competitive pressures kept mutual funds from using NASD recapture made no suggestion that there was any duty to recapture in the face of such pressures, thereby appearing to accept them

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* Fiske, *The Budge Commission Takes Over in Washington,* INSTITUTIONAL INVESTOR, June 1969, at 37. *See also* Securities Exchange Act Release No. 11203 (Jan. 23, 1975), [1974-'75] CCH FED. SEC. L. REP. ¶ 80,067, at 84,992.

** Fiske, *supra* n.*.

as a proper reason for not engaging in the practice. (Ex. 4, at 147a) The suggestion in the 10b-10 release that there might be a duty to recapture accompanied a tentative rule which would have mandated recapture and would have applied to all mutual funds at once and hence would have obviated this competitive pressure.

In early 1967, Commissioner Loomis, while still General Counsel for the SEC, made the following remarks at a colloquium on the mutual fund industry, making it clear that he did not believe there was any duty on the part of mutual fund managers to recapture:

> "Herb Anderson's remarks seemed to indicate at least part of the confusion that has surrounded this problem. He appears to feel that our objection to customer directed give-ups is a criticism of the funds and of the fund managers, and that the fund managers, or the NASD, or the I.C.I., should do something about it. We don't look at it that way — at least, I don't. So long as the stock exchange rules permit this way of doing things, I don't particularly blame the funds for doing it, and the NASD and the I.C.I. have no power to change the rules of the stock exchanges anyhow.
>
> "So long as the stock exchange rules permit this practice, it is to be expected that the funds will do something with these commissions, rather than not do anything with them. Thus, we view this as a problem of exchange rules, not as a practice in which the funds or their managers or the NASD or the I.C.I. are in any way delinquent. Of course, this system does create, as the report points out, and as Bob and I have mentioned, an incentive for funds, and perhaps for fund salesmen, to do things which raise

questions. But by and large this is not a problem of any misconduct on the part of funds or fund managements, but, in our view, a defect in the exchange commission rate structure." 115 U. of Pa. L. Rev. 661, 835 (1967).

Later in 1969 he made a similar statement as follows:

> "You first asked whether mutual fund management has a fiduciary duty to acquire a stock-exchange seat, directly or through an affiliate, in order to utilize this means to recapture brokerage which in turn will be offset against management charges. We do not believe that management has this duty if in the exercise of its best business judgment management determines that it is not in the best interest of the fund to create such an affiliate." Ex. I, Securities Exchange Act Release No. 8746 (Nov. 10, 1969), [1969-70] CCH Fed. Sec. L. Rep. ¶ 77,761, *at* 83,747.

On April 20, 1972, SEC Chairman Casey testified as follows in Congress to the general effect that institutional membership would probably not help mutual funds:

> "If an institution were an exchange member, it would be prone to do all or almost all of its portfolio business for itself at actual cost. Many lawyers might well advise institutional managers that it is a breach of fiduciary duty to pay commissions to unaffiliated brokers for work that could be done at raw cost by their very own captive or shell brokers. But this would cut off the institutions — that is, their beneficiaries — from the rich variety of execution and research skills available when they buy brokerage services from bona fide brokers. One poor execution, one passed up piece of topnotch analytical research, could well consume the fruits of many months of

> laborious cheeseparing on direct commissions. On balance, we think it highly doubtful that institutional membership would result in any net saving at all for the beneficiaries on whose behalf or alleged behalf it is being fought so rigorously." Securities Industry Study, Hearings before House Subcom. on Commerce and Finance, Part 9 (Appendix), 92d Cong., 2d Sess. at 4384, 4388-9.

Many excellent opportunities to enter advantageous portfolio transactions might first be shown to others instead of to a fund which had a dummy broker whose only function was to siphon off portions of commissions.*

Plaintiff's contention that there is a duty to recapture is primarily based on the claim that recapture was required by a provision in the Fund's charter which requires that the Fund receive the net asset value of shares sold to investors. This theory is illogical because it assumes that the portions of commissions which plaintiffs claim could have been recaptured might properly be regarded in the accounting sense as assets of the Fund even before they were recaptured. However, plaintiff introduced no evidence to establish that these are properly classified as assets and in view of the dubious legality of recapture, as shown in Point I, *supra,* no such showing could be made.

One of the basic assumptions in plaintiff's argument is that the charter states how net asset value is to be calculated. In fact, this is governed by Sections 11 and 22 of the Investment Company Act (15 U.S.C. §§ 80a-11; 80a-22) which provide that such computation will be governed by rules prescribed by the SEC. Rule 2a-4, 17 C.F.R. § 270.2a-4

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* For other reasons for not recapturing, see Miller and Carlson, *Recapture of Brokerage Commissions By Mutual Funds,* 46 N.Y.U.L. Rev. 35, 46-51 (1971).

(1975), adopted thereunder states that "current net asset value" is to be used in calculating prices when distributing mutual fund shares and that "expenses" and "income" shall be included but does not otherwise define these terms and says nothing whatever about the inclusion of allegedly recaptureable commissions in such calculations.*

Moreover, the charter argument is fallacious because it assumes that the Fund could not incur expenses for any sales purposes such as printing prospectuses, registering shares pursuant to the Securities Act of 1933 with the SEC or with state securities commissions and other distribution costs. There is no basis for any such theory.

Further, the charter contention is inappropriate in a derivative action because it assumes that every fund shareholder, including plaintiff, paid less (because allegedly recaptureable commissions were not included in the net asset value which determined their purchase price) than he or she should have paid for his or her respective shares. These amounts would vary from shareholder to shareholder. Be-

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* The requirement of the Rule that "expenses" and "income" shall be included in the calculation of "current net asset value" for use in computing the price of Fund shares is subject to the limitation that items which would otherwise be required to be reflected

> "need not be so reflected if cumulatively, when netted, they do not amount to as much as one cent per outstanding share. . . ."

Net asset value is calculated at least once each business day. Even assuming arguendo that outstanding allegedly recaptureable commissions constituted "expenses" or "income", there is no evidence that on any such day the amount thereof was sufficiently large so that, when netted with other expenses and income, the balance was not small enough to fall within the one cent per share exemption. For this additional reason there is no basis for plaintiffs' contention that the charter was violated because of any improper calculation of net asset value.

fore there can be any recovery which benefits any such shareholder, each shareholder logically should be charged with the amount which he or she underpaid. This would be an extremely difficult computation. There is no equity in allowing plaintiff, who according to her theory paid too little for her stock, to sue because other shareholders allegedly received similar benefits. For these reasons a shareholder of the corporation such as plaintiff who claims to have bought watered stock has no standing to complain that other shareholders were accorded similar treatment. 11 Fletcher, Corporations § 5229 (1971).

The only authority which plaintiff can cite for the alleged charter requirement is dictum in the Court of Appeals opinion in *Moses v. Burgin, supra,* 445 F.2d at 373-74, to the effect that the fund involved in that case was required to recapture give-ups if they were "freely available." The balance of the opinion makes it clear that that court considered give-ups were "freely available" only if it was known that they could be recaptured lawfully. However, the holding of liability in that case was based not upon the charter theory but rather upon the willful and deliberate failure of the adviser to inform the unaffiliated directors about the "possibility" of recapturing give-ups, the fact that when the unaffiliated learned of this "possibility" they elected to engage in it (and take the associated legal risks), and the conclusion that if they had been notified sooner of the "possibility" they would have embraced it sooner (445 F.2d at 377-9). In the instant case there was no such lack of disclosure, no knowledge by defendant of any proper possibility of recapture, and all of the unaffiliated directors were opposed to recapture by plaintiffs' methods. Def.-Appellees' Brief pp. 13-23.

Any suggestion that *Moses* applies to such facts or stands for more than this limited principle of "disclosure" has been rejected by district courts in both the First and Second Circuits. *See Schlusselberg* v. *Colonial Management Associates, Inc.*, 389 F. Supp. 733, 736-7 (D. Mass. 1974); *Schlusselberg* v. *Keystone Custodian Funds, Inc.*, [1973] CCH Fed. Sec. L. Rep. ¶ 93,901, at 93,613 (S.D.N.Y. 1973); *Marcus* v. *Putnam*, 60 F.R.D. 441, 446 (D. Mass. 1973); *White* v. *Auerbach*, [1972-73] CCH Fed. Sec. L. Rep. ¶ 93,617, at 92,828 (S.D.N.Y. 1972); *Weiss* v. *Chalker*, 59 F.R.D. 533 (S.D.N.Y. 1973.)

Recently, in *Tannenbaum* v. *Zeller*, CCH Fed. Sec. L. Rep. ¶ 95,257 (S.D.N.Y. July 30, 1975), Judge Carter held that there was no duty to recapture in a situation in which he assumed recapture was freely available. He said the following about *Moses* v. *Burgin*:

> "Moreover, in view of the developments since *Burgin* one can be certain that whatever doubts might exist as to whether its basic thrust was non-disclosure, rather than a mandate that regional exchanges be utilized to secure 'give-ups' for reduction of management fee, there is little doubt in my mind that non-disclosure is the only precedential value that *Burgin* now retains." (p. 98,331)

Under the foregoing authorities it is clear that defendants made sound and proper use of the fund's brokerage for the fund's benefit and that under the business judgment rule, *Fogelson* v. *American Woolen Co.*, 170 F.2d 660, 662 (2d Cir. 1948), they had no duty to act differently.

CONCLUSION

For the foregoing reasons, the decision below should be affirmed.

September 4, 1975.

Respectfully submitted,

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